

BUSINESS FINANCE ASSIGNMENT

UNIT 1 & 2

Q1. A)

Category	Traditional Partnership	LLP
Ownership	A partnership is a business which is owned by more than one person. The partnership may be owned in equal or unequal amounts by the partners.	The LLP is a separate legal entity. Any firm consisting of two or more members (not partners) engaged in a profit-making venture, may become a LLP.
Liability	The owners have unlimited liability. All the partners are jointly liable for any business debts. They will also be 'severally liable', that is, each partner is liable to the full extent of their personal estate for the deficiencies of the partnership.	Whilst the LLP itself is responsible for its assets and liabilities, the liability of its members is limited. Actions may be taken against individual members who are found to be negligent or fraudulent in their dealings.
Documentation	Most partnerships will have a 'partnership agreement' which sets out the rights of individual partners. The partnership agreement might specify, for example, who can make what decisions and how profits are shared between partners.	In general terms, a LLP is governed by the partnership agreement that may already be in force within an existing partnership. In the absence of any agreement, the mutual rights and duties will be governed by the default provision contained in the regulations. A LLP has to be registered at Companies House. An incorporation document must be submitted and signed by at least two persons, who will become the first members of the LLP.

I would suggest the 4 medical practitioners to set up a LLP. A LLP gives the benefits of limited liability whilst retaining other characteristics of a traditional business partnership. Also there is no double taxation, that is the members of a LLP have to pay personal income tax only and no taxes on the company's profits. Thus, the limited liability that a LLP offers is the main reason why the practitioners should prefer a LLP over a partnership.

Q2. A)

The statement is not entirely true as the shareholders also take into consideration other factors while valuing a company.

It is a fact that shareholders are interested in maximising the value of their investments in shares. They want high returns on their investments. A company which has higher earnings will be given more value by the shareholders as higher earnings implies increasing profits which will automatically attract the investors and result in increasing the share price. Higher earnings also imply a strong and wise board of directors and senior management whose strategic decisions to make wise investments generated a healthy return on invested capital.

However, the shareholders also take into consideration the social responsibilities undertaken by the company and their ethics of practicing business. The shareholders look into the ways by which the company is generating profits. Companies' reputations can be seriously damaged if they are found to be untrustworthy or thought to be unethical, and there can be serious consequences for the share price.

Thus, shareholders also value the company on the basis of their business ethics and social responsibilities undertaken by them. The CFO must strive to maximise shareholder wealth within external constraints such as social responsibilities and business ethics.

Q3. A)

As an investor Mr. Kevin must subscribe to a convertible preference shares. Convertible preference shares are preference shares which give the right to convert into ordinary shares at a later date. The investor does not pay anything to convert other than surrendering the convertible preference shares. This means the investor is able to get the best of both worlds. The investor also has the option to not convert into ordinary shares if he believes that the company isn't performing well.

Ordinary shares (ESC) offer investors the potential for high returns but shareholders take a great risk, particularly the risk of capital losses. Dividends can be volatile, as can the market values of the shares. It is not mandatory for the company to pay dividends to the shareholders. Dividends also depend highly on the performance of the company that is the profits made by it. When companies are wound up, ordinary shareholders often end up with nothing as they rank below creditors and usually rank below preference shareholders. So, ordinary shares in most companies are risky.

Preference shares (PSC) offer the investor a lower risk than ordinary shares and therefore a lower expected rate of return. Preference shares offer a relatively predictable future income stream, but uncertainty about the return of capital in the event of a winding-up. However, the variability of return will be significantly less than that of ordinary shares, because a preference share's capital value will fluctuate much less than the capital value of an ordinary share. The crucial difference between preference shares and ordinary shares is that preference share dividends are limited to a set amount which is almost always paid. It is usual for the preference shareholders to get voting rights whilst their dividends remain unpaid. Preference shares rank below loan capital and above (or equal to) ordinary shares if the company is wound up. In a given company, the risk of preference shareholders not getting their dividends is greater than the risk of loan stockholders not being paid, but less than the risk of ordinary shareholders not being paid.

Thus, a convertible preference share will be best for Mr. Kevin as an investor.

Q4. A)

Public Limited Companies	Private Limited Companies
Public limited companies offer shares to the general public and shareholders have limited liability.	All other limited companies are classed as private limited companies
A public limited company is a company whose documentation states that it is a public company and which has an issued share capital of at least £50,000.	A private limited company is not allowed to offer its shares to the public. It is a requirement of the Stock Exchange that a company that wants to have a full Stock Exchange listing must be a public limited company.
The name of a public limited company must end with the words 'public limited company' or the abbreviation PLC or plc.	A private limited company's name must end with the word 'limited' (or the abbreviation LTD or ltd).
A public limited company must be 'correctly registered' with the Registrar of Companies at Companies House.	Private companies are more typically small companies with a narrow range of shareholders, often being 'family run' businesses.
All public companies must produce audited accounts.	Audited accounts publication not necessary

Q5. A)

A Proprietorship is a business which is owned by one person and which is not a limited company.

Pros:

- A proprietorship is very easy to set up.
- A sole trader takes all the decisions of the business. He doesn't have to take approval of any partners or a board before taking any decision. The sole trader can decide what to do with the business (eg run it themselves, hire managers to run it, pass it on to a family member).
- The sole trader can draw out money from the business as needed.
- No specific documentation is needed to legally establish this form of business entity.

Cons:

- The legal identity of the owner and the business is the same.
- The sole trader has unlimited liability. This means that if a customer sues the sole trader (for breach of contract for example), the total personal wealth of the sole trader, including the sole trader's house and bank deposits, would be available to pay off trading liabilities.
- A proprietorship cannot also obtain large funds for investments due to their limited liability. They do not have their stocks traded in the market. Thus, most of the financial burden of running the business lies on the sole trader's shoulders.

Q6. A)

The methods to raise short term funds for working capital needs are:

1. **Bank overdrafts:** An overdraft is a form of short-term borrowing from a bank where the borrower is granted a facility to draw money out of a current account such that it becomes negative, down to an agreed limit. The borrower pays interest only on the amount by which they are actually overdrawn. No explicit capital repayments are made. Overdrafts made to companies are usually secured by a floating charge. Interest rates are almost always variable, often on a daily basis. A bank can demand immediate repayment of an overdraft with no notice.
2. **Trade credit:** Trade credit is an agreement between a company and one of its suppliers to pay for goods or services after they have been supplied. Trade credit is available from almost all suppliers of goods and services to their business customers. Typically, after goods are delivered, the business customer will be sent an invoice demanding payment within a set period, e.g. 28 days or 91 days. In most cases no explicit interest is charged. In many industries, late payment is so common that explicit discounts can be negotiated for not using trade credit. Using trade credit is a way for businesses to obtain 'free' finance. The problem with using (or more likely abusing) trade credit is that it can damage a company's relationship with its suppliers.
3. **Factoring:** Trade credit can cause problems for the suppliers of goods. An alternative way of financing the trade credit that they have to give is to use factoring. There are two types of factoring: 'non-recourse factoring' and 'recourse factoring'.
 - a) **Non-recourse factoring:** Non-recourse factoring is where the supplier sells on its trade debts to a factor in order to obtain cash payment of the accounts before their actual due date. The factor takes over all responsibility for credit analysis of new accounts, payment collection and credit losses. Using a factor gives the supplying company money earlier than if it had to wait to be paid, protection against bad debts, and an administrative service. However, the factor will want to get the customers to pay up as soon as possible, so may put excessive pressure on the supplying company's customers. This could have a negative effect on the supplier's future business with these customers.
 - b) **Recourse factoring:** A copy of the invoice is sent to the factor who then gives the supplying company the money up front. However, the supplying company is still responsible for collecting its debts (so its customers are not contacted by the factor). When the supplying company eventually gets paid by a customer, it passes the money on to the factor. The factor has no control over the debt collection process, so it charges the supplying company interest on the money that it has paid from the date the advance was made to the date that the supplying company gives the factor the money.
4. **Bills of exchange:** A bill of exchange is effectively a claim to the amount owed by a purchaser of goods on credit and may be 'accepted' by a bank (for a fee). This means that the bank guarantees payment against the bill to whomsoever holds the bill at maturity. The bill can then be sold to raise short-term finance. An eligible bill of exchange can then be sold on to a discount house or a bank which will pay a price below the face value of the bill. Bills of exchange are known as 'two name' papers because they carry both the name of the company which owes the money and the name of the accepting bank.

5. **Commercial Paper:** Commercial paper is a form of short-term borrowing by large companies. Commercial paper is a type of bearer document, ie there is no register of holders. Payment is made to whoever presents the piece of paper at the end of the term. Commercial paper is issued at a discount and later redeemed at its face value. By buying a new issue of commercial paper, investors are effectively lending money to companies for an agreed period (ranging from one week to one year). These instruments may be described as 'single-name'. The security is provided only by the company issuing the paper (ie borrowing the money). This contrasts with bank bills described above which have two names: the issuer and the bank that endorses the bill.

Q7. A)

A lease is an agreement where the owner of an asset gives the lessee the right to use the asset over a period of time, in return for a regular series of payments. Legal ownership does not change hands. A lease is simply an agreement for the 'lessee' to rent from the 'lessor'.

There are two types of leases: operating leases and finance leases. The difference hinges on the length of the lease in relation to the expected economic life of the asset.

Operating Leases: Under an operating lease, the owner of the asset will retain most of the risks associated with owning the asset. The lease will be for a period substantially shorter than the likely life of the asset.

Financial Leases: Under a finance lease, the lessee takes on most of the risks associated with owning the asset. The lease will be for a period similar to the likely life of the asset. In effect, in using a finance lease the lessee is in a similar position to buying the asset outright, but financing this by paying rent rather than by paying a lump sum up front.

Q8.A)

i. **Convertible:** Convertible forms of company securities are, almost invariably, unsecured loan stocks or preference shares that convert into ordinary shares of the issuing company. Convertible preference shares are preference shares which give the right to convert into ordinary shares at a later date. The investor does not pay anything to convert other than surrendering the convertible preference shares. Convertible unsecured loan stocks are unsecured loan stocks which give the right to convert into ordinary shares of the company at a later date. If the holder chooses not to convert, then the security might continue as a loan stock or preference share for a period of time.

ii. **Warrant:** Warrants are call options written by a company on its own stock. The purchaser of a warrant has the right but not the obligation to buy a fixed number of the company's shares at a fixed price (known as the 'strike price') at a fixed date. Taking up this right is known as 'exercising'. When they are exercised, the company issues more of its own shares and sells them to the option holder for the strike price. The exercise of a warrant leads to an increase in the number of shares that are outstanding. This, in turn, leads to some dilution in the value of the equity.

iii. A convertible must normally trade at a price higher than equity stock as it has the value of a loan stock in addition to being converted to an equity at any time. So the value of the convertible is equalled to the value of the stock + the value addition of being a convertible.

iv. The running yield of a convertible must be greater than equity because of the mandatory dividend or coupon payments in preference shares and loan stocks. Preference shareholders have a preferential right to either dividends, or return of capital, or both, compared to ordinary shareholders. In a loan stock the company has to make mandatory coupon payments to the investors. Ordinary shareholders may not receive dividend payments at times but preference shareholders always do. Also, equity is an underlying part of the convertible, thus an increase in the share price increases the value of the convertible. Also, the dividends or coupons received from a preference share or loan stock are usually more in value than the dividends received on ordinary shares. The dividend payment is fixed and does not depend to the same extent on the short-term profits' growth of the company. The security of dividend payments for a convertible is higher than that of an ordinary share, and the option to convert to an ordinary share or leave it as a fixed-interest security allows the investor to be sure of a minimum expected return. Thus, the running yield of a convertible is greater than the equity.